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Compliance Considerations for Spot Cryptocurrency ETFs

By Craig Watanabe and Ryan Smith

On January 11, 2024, the SEC approved 11 spot Bitcoin ETFs for trading. Importantly, these spot Bitcoin ETFs will own Bitcoin directly and not Bitcoin futures which is a distinction with a significant difference. Below are factors that compliance officers are well-served to consider when encountering this and similar products.

Characteristics of the Cryptocurrency Markets

Before delving into the specifics of the spot Bitcoin ETFs, it will be instructive to understand characteristics of the cryptocurrency markets. A cryptocurrency is a digital currency relying on a decentralized system (sometimes referred to as “distributed ledger technology” or “blockchain”) to verify the validity of transactions between parties. Being decentralized means there is no need for intermediaries such as banks or payment processors to facilitate transactions. Bitcoin was the first cryptocurrency created in 2009. As of June 2023, there were more than 25,000 cryptocurrencies, but Bitcoin remains the leader as it represented about 48% of the cryptocurrency market by market capitalization.[1] The six largest cryptocurrencies according to Yahoo Finance were:[2]

Cryptocurrency	Market Cap
Bitcoin	821.02B
Ethereum	272.84B
Tether	96.0B
Binance Coin	45.50B
Solana	40.26B
Ripple	28.85B

One of the primary risks of cryptocurrencies is volatility, owing, in part, to its decentralized nature. As measured by average daily price fluctuations, different cryptocurrencies can fluctuate wildly. Here is a table of average daily percent change from 2018 to 2022.[3]

Asset	Avg Daily % Chg
Cardano	4.44%
Ripple	4.04%
Binance	4.01%
Ethereum	3.76%
Bitcoin	**2.87%**
Russell 2000	1.17%
S&P 500 Index	**0.90%**
Gold	0.67%
Tether	0.20%
USD Coin	0.18%
Binance USD	0.15%

The volatility of cryptocurrencies varies greatly with Cardano being 30 times more volatile than Binance USD, which is a cryptocurrency known as stablecoins whose value is pegged to the US Dollar. Turning to the new Spot ETFs, from 2018 to 2022, Bitcoin was 3.19 times as volatile as the S&P 500 Index.

Bitcoin ETFs

One of the first and largest Bitcoin ETFs is GBTC, which was formed in 2013. The table below clearly indicates that GBTC is extremely volatile. Here is the annual performance of GBTC for the past 10 years:

Year	Return
2014	-59.96%
2015	+33.37%
2016	+119.88%
2017	+1,391.44%
2018	-74.61%
2019	+87.69%
2020	+291.86%
2021	+60.61%
2022	-65.59%
2023	+148.74%

Some negatives are GBTC has been plagued by large tracking errors because Bitcoin exposure was via Bitcoin futures. Recently, GBTC traded at a 42% discount to NAV.[4] GBTC has also offered high expense ratios, historically over 2% but currently at 1.5%.

Spot Bitcoin ETF Expense Ratios

Since the Spot ETFs are very similar and highly correlated, expense ratios are a larger factor in assessing whether the investment is appropriate for an investor. Here is a table with data provided from Morningstar as of May 14, 2024.

ETF	Symbol	Expense Ratio
Bitwise Bitcoin ETF	BITB	0.20 percent
ARK 21Shares Bitcoin ETF	ARKB	0.21 percent
Fidelity Wise Origin Bitcoin Trust	FBTC	0.25 percent
Wisdom Tree Bitcoin Fund	BTCW	0.30 percent
Invesco Galaxy Bitcoin ETF	BTCO	0.39 percent
Valkyrie Bitcoin Fund	BRRR	0.49 percent
iShares Bitcoin Trust	IBIT	0.25 percent
VanEck Bitcoin Trust	HODL	0.25 percent
Franklin Bitcoin ETF	EZBC	0.29 percent
Grayscale Bitcoin Trust	GBTC	1.50 percent

Risks

The risks associated with investing in cryptocurrencies are well-documented. The SEC's Office of Investor Education and Advocacy has been warning investors about the risks associated with Bitcoin and virtual currencies for at least a decade.[5] It issued two more notices about the risks associated with securities related to cryptocurrencies in the more recent past.[6] In fact, even in approving the Spot Bitcoin ETFs, Chair Gensler noted "[w]hile we approved the listing and trading of certain spot bitcoin ETP shares today, we did not approve or endorse bitcoin. Investors should remain cautious about the myriad risks associated with bitcoin and products whose value is tied to crypto."[7]

Although the Spot Bitcoin ETFs are registered and regulated by the SEC, the underlying cryptocurrencies are not.[8] Commissioner Crenshaw noted in her dissent to the approval of Spot Bitcoin ETFs that "Spot Bitcoin ETPs will be participating in an unregulated, fragmented, continuously traded, global free-for-all."[9] The primary risk is Bitcoin is only worth what someone else is willing to pay. The volatility described above is symptomatic of the uncertainty of the value. Moreover, Bitcoin custodians do not hold the cryptocurrency, but the keys to it.[10] As such, the Spot Bitcoin ETFs, and by extension their investors, are subject to all of the risks presented by Bitcoin, including fraud risks.

Based on the initial interest and success of the Spot Bitcoin ETFs, it is reasonable to expect other spot cryptocurrency ETFs in the not-too-distant future. Compliance officers are well advised to plan now.

Four Compliance Considerations to Manage the Risk

1. Firm Policies – The Spot Bitcoin ETFs are expected to be very popular, so it is advisable for firms to determine if their current policies can accommodate these volatile assets.[11]

    a. One policy would be to limit trading in Bitcoin ETFs to unsolicited or unadvised transactions only. Firms that have a similar policy for leveraged and inverse ETFs can leverage this control for this new product.

    b. If solicited transactions in Spot Bitcoin ETFs are allowed – and note that such transactions would be subject to Regulation Best Interest or the fiduciary standard of care[12] – then firms can have other policies such as deploying concentration limits and/or requiring investors receive additional risk disclosures before and/or after the transaction (see below). Concentration limits are common with other assets such as alternative investments and complex investments such as annuities and structured products.

2. Existing Controls – One possible policy is to rely on existing controls such as initial and ongoing suitability reviews. If the firm has adequate oversight of trading and portfolio management, this is a reasonable policy.

3. Training – Regardless of firm policies, most firms will want to do training on the Bitcoin ETFs. Training is beneficial and has little downside. This article can provide a foundation for the firm training.

4. Disclosure:

a. Point-of-Sale (POS) Disclosures – Firms may want to create point-of-sale disclosures, like what most firms do with alternative investments and annuities. A sample template is included with this article. Some disclosures require investors to make certain representations and warranties to the firm. Some also require signatures. Others, however, are designed to inform investors. The included template falls into the latter category and does not require client signatures.

b. Post-trade Disclosures – Disclosure is a reasonable control and rather than point-of-sale, disclosure can be provided after the transaction. Post-trade disclosures typically have a cover letter thanking the client for their business and include a disclosure such as the SEC's Risk Alert on Cryptocurrencies from March 2023. The included template could also be used as a post-trade disclosure, however, post-trade disclosures will not satisfy the requirements of Reg BI, and are not as strong a control as POS disclosures. Still, there may be some utility in providing post-trade disclosures.

The four compliance considerations can be employed singularly or in combination.

Conclusion

The 11 new Spot Bitcoin ETFs are popular and there has been – and will continue to be – interest from clients and advisers. Firms are well-served to consider appropriate controls to manage the risk posed by these products now.

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[1] ***See*** "Cryptocurrencies: What Are They", Charles Schwab (August 23, 2023), available at: Cryptocurrencies: What Are They? | Charles Schwab

[2] ***See*** "Top Cryptos by Market Cap", Yahoo Finance (January 27, 2024), available at: Cryptocurrencies with Highest Market Cap – Yahoo Finance

[3] ***See*** "Examining Day-To-Day Crypto Volatility and Why It's Important", Max Gulker and Jordan Campbell, Reason Foundation (March 8, 2023), available at: An interactive look at day-to-day crypto volatility (reason.org)

[4] ***See*** "World's Biggest Crypto Fund Hits Record 42% Discount to Value of Bitcoin it Holds", Bloomberg (November 21, 2022), available at: Biggest Crypto Fund (GBTC) Hits Record 42% Discount to Bitcoin (BTC) Value – Bloomberg

[5] ***See*** "Investor Alert: Bitcoin and Other Virtual Currency-Related Investments", United States Securities and Exchange Commission (May 7, 2014), available at https://www.sec.gov/oiea/investor-alerts-bulletins/investoralertsia_bitcoin.

[6] ***See*** *Funds Trading in Bitcoin Futures – Investor Bulletin* (June 10, 2021) and *Exercise Caution with Crypto Asset Securities: Investor Alert* (March 23, 2023), available at https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_fundstrading and https://www.sec.gov/oiea/investor-alerts-and-bulletins/exercise-caution-crypto-asset-securities-investor-alert, respectively (last visited March 27, 2024).

[7] Gensler, Gary, *Statement on the Approval of Spot Bitcoin Exchange-Traded Products* (Jan. 10, 2024), available at https://www.sec.gov/news/statement/gensler-statement-spot-bitcoin-011023 (last visited March 27, 2024).

[8] Supra Note 6 at 3.

[9] Crenshaw, Carolyn, *Statement Dissenting from Approval of Proposed Rule Changes to List and Trade Spot Bitcoin Exchange-Traded Products* (Jan. 10, 2024), available at https://www.sec.gov/news/statement/crenshaw-statement-spot-bitcoin-011023 (last visited March 27, 2024).

[10] *Self-Regulatory Organizations; NYSE Arca, Inc.; The Nasdaq Stock Market LLC; Cboe BZX Exchange, Inc.; Order Granting Accelerated Approval of Proposed Rule Changes, as Modified by Amendments Thereto, to List and Trade Bitcoin-Based Commodity-Based Trust Shares and Trust Units*, SEC Rel. No. 33-99306 (Jan. 10, 2024) at 18.

[11] FINRA explicitly encourages its member firms to do in its *2024 FINRA Annual Regulatory Oversight Report*, (the "Report") noting that engaging in cryptocurrency or related transactions implicate supervisory programs and controls involving, among others, communications with the public and due diligence. See Report at 21.

[12] Supra Note 11 at 15-16. See also supra Note 8.

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